# INITIAL COMMENTS OF

# BAY STATE GAS COMPANY

## MASSACHUSETTS DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY
## D.T.E. 98-32

**May 1, 1998**

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## EXECUTIVE SUMMARY

On April 3, 1998 the Department of Telecommunications and Energy ("Department") invited the ten Massachusetts LDCs and other stakeholders to submit proposals regarding capacity assignment, cost responsibility and all other issues that need to be resolved by the Department in order to offer unbundled service or "choice" to all retail natural gas customers in Massachusetts. Bay State brings a unique perspective to these issues based on its pilot experience providing choice to 100,000 of its residential and small commercial customers and its collaborative efforts to design and implement a partnership relationship with the regional and national marketers who will be providing complementary products and services to customers in the future.

Bay State conducted its pilot as an essential first step prior to opening up our entire system to choice, and our proposal reflects the significant learning that the pilot yielded. Bay State believes that its two-year pilot experience provides the most relevant evidence available to the Department for two reasons. First, the pilot was successful in attracting strong interest among suppliers and residential and small C&I customers because of the collaborative effort that led to a relatively "open" design which approached conditions in a competitive market. Second, and perhaps most importantly, Bay State's pilot is the only residential program in New England. This latter point is of particular importance due to the unique upstream and downstream capacity situation and growth opportunities for natural gas that exist in New England and affect the design and success of a customer choice program.

The ongoing market research effort is designed to measure attitudes toward choice among Massachusetts customers. It has been performed by an independent market research firm in four "waves" and the results have been broadly distributed by Bay State. This market research suggests that (1) the vast majority of customers require measurable (5-15%) savings in order to select a competitive supplier, (2) a significant percentage of non-participating customers indicated that they that they are not interested in customer choice

at this time because they prefer Bay State as their supplier, and (3) non-participating customers still value having a competitive alternative even if they remain Bay State sales customers. Our customers clearly want Bay State to remain one of the supply choices at this time. The research also indicates that our customer satisfaction has remained very high among both participants and non-participants, which we attribute both to the design of the program and the customer communication and education efforts that accompanied it. Customer attitudes will continue to change as both electric choice and natural gas choice become available and therefore Bay State's market research efforts will continue.

Based in part on this experience, Bay State encourages the Department to adopt an approach that will provide for continuing monitoring, evaluation and adjustments over the next few years as increasingly valuable and relevant experience is gained. This approach is necessary in order to ensure that all customers will benefit from the development of a competitive retail gas market. The transition from a heavily regulated, bundled environment to a less regulated, unbundled environment will require the Department to balance many competing objectives.[1] The Department will also need to apply its judgment where it is not yet evident how the market will respond to the competitive framework that will be established in this proceeding. This supports the likely need for adjustments during the transition period.

Bay State's proposal for achieving the Department's goals is comprehensive and will maximize the benefits of a competitive market to customers who are ready for choice as well as to those customers who choose to remain as sales customers at least for the time being. As part of its proposal, Bay State urges the Department to resist mandating that all LDCs must exit the merchant function by a set date because there is no value, and potential harm, from making this decision before evaluating the experience that will

[1] In its July 18, 1997 letter initiating the Massachusetts Gas Unbundling Collaborative (MGUC), the Department cited four goals for natural gas unbundling. These are: (1) provide the broadest possible choice, (2) provide all customers with an opportunity to share in the benefits of increased competition, (3) ensure full and fair competition in the gas supply market, and (4) separate the supply function from local distribution services. Participants in the Bay State collaborative also developed a set of Guiding Principles for designing a full customer choice model; these are provided as Attachment A to these comments.

begin after this order is issued. Based on this assessment, recalibration of the unbundling policies and design parameters can and should be made. Our proposal blends many of the approaches proposed by parties in their attachments to the March 18, 1998 Status Report. Our proposal establishes a structure that will allow the competitive market to develop in a meaningful way for customers, which requires that retail marketers have the ability to offer customers measurable benefits. Bay State believes that this was one of the critical success factors for its pilot program.

The key elements of Bay State's proposal are summarized in the table at the end of this Executive Summary. LDCs would continue to offer a regulated sales service ("Utility Sales Service") which would be available to new and returning customers throughout the transition period. LDCs also would retain responsibility for capacity planning during the transition period, with Department oversight of capacity renewal and other contracting decisions. Under our proposal, LDCs may outsource all or parts of the city-gate supply needed to provide these services, but are not required to do so. Upstream pipeline and storage capacity will be assigned to retail marketers on a "75-75" basis (75% mandatory assignment with a minimum recovery of 75% of the remaining costs, net of mitigation, from transportation customers), providing marketers with the capacity that they need while also minimizing the potential for transition costs. Retail marketers will also have access to the LDC's LNG and other local production assets providing them with the ability to meet the seasonal and daily swing requirements of their firm customers.

Bay State's proposal focuses on delivering measurable benefits of choice to customers, while addressing the potential burdens that some customers may perceive. Under Bay State's proposal, all customers will have a true choice among competitive suppliers on November 1, 1998. This results from creating an environment in which every customer will be offered a competitive alternative to the LDC sales service. Customers who elect to choose the LDC rather than an alternative supplier will still benefit significantly from the competitive environment that is fostered and allowed to mature. Finally, Bay State's proposal includes elements that address potential costs that may result from the transition

to a competitive market in an effort to both minimize stranded costs and the potential for cross-subsidization between competitive and regulated sales service.

In addition to addressing customer choice on a generic basis, Bay State draws the attention of the Department to the fact that it has over 27,000 residential and small commercial & industrial customers who are receiving service from one of 10 participating marketers in its pilot and an additional 2,000 medium and large C&I customers who are receiving service under other transportation tariffs. Many other Massachusetts LDCs also have customers receiving transportation service. After the Department provides policy guidance in this proceeding, Bay State requests that the Department afford it the opportunity to assess the impact on existing pilot and transportation customers and propose to the Department any interim services to make the transition to the new transportation services more acceptable, including a potential request to extend the pilot terms and conditions. Bay State anticipates working with its customers, the most active retail marketers, the Department and other stakeholders that contributed to the pilot design to accomplish this objective. Bay State feels that it is extremely important that those customers who have opted for choice early continue to have a positive experience as the industry advances to full customer choice.

**Summary of Bay State's Customer Choice Proposal**

| Design Element | Bay State Proposal | Reasoning |
|---|---|---|
| 1. **Utility Sales Service ("USS")**<br><br>(Reference: page 9) | LDCs continue to offer a regulated alternative throughout the Transition Period. Customers can return to USS without limitation. LDCs that have class-specific Cost of Gas Adjustment mechanisms (CGAs) may retain them. | USS "establishes a bar" that marketers must meet in order to attract customers, provides assurances to customers who enter the competitive market that the LDC will continue to be an alternative in the event that they are dissatisfied (a level of comfort which facilitates migration), allows customers to experience new product offerings and provides protection to customers who elect to defer choosing a retail marketer as their supplier. Class-specific CGAs provide a cost-based benchmark for marketers to compete against. |
| 2. **LDC Exit From the Merchant Function**<br><br>(Reference: page 10) | A determination that LDCs exit the merchant function by a date certain should not be made because it would be premature prior to gaining further experience with customer choice. At that point, alternative approaches to providing the benefits of competition to customers who have not yet elected a competitive supplier can be considered. | The market is not sufficiently developed in order to determine that it is appropriate for LDCs to exit the merchant function. There is no benefit, and potential harm, to establishing an arbitrary date for exiting the merchant function at this time. It is more important to concentrate on design features that will "pull" customers toward competitive service and to create a "push" only after substantive learning and migration has taken place. |

| Design Element | Bay State Proposal | Reasoning |
|---|---|---|
| 3. Portfolio Outsourcing<br><br>(Reference: page 11) | LDCs may outsource the city-gate supply service if it is in the best interests of their customers. | Outsourcing of the supply service by LDCs should only be implemented if it provides incremental benefits to sales customers. The outsourcing of LDC portfolios is not directly linked to customer choice and the decision should be made at the discretion of LDCs independent of the Department's ultimate policy decisions on unbundling. |
| 4. Temporary Sales Service ("TSS")<br><br>(Reference: page 11) | Medium and large C&I customers who return to bundled sales service during the winter will be required to return to TSS. TSS will be priced to reflect the higher costs imposed by customers who are large enough to require the LDC to adjust its portfolio after the winter has begun. | Small customers can return to USS without any significant impact on gas supply costs; the return of medium and large C&I customers during the winter who are more sophisticated energy buyers may result in higher costs to serve, which should not be borne by other customers. |
| 5. Upstream Capacity Assignment<br><br>(Reference: pages 12-13) | Marketers are required to take assignment of 75% of the upstream transportation and storage capacity offered, and to guarantee recovery of 75% of the costs attributable to the balance. | This represents a balancing of the desires to minimize transition costs, make necessary capacity available to provide firm service, and provide marketers with portfolio flexibility. |
| 6. Access to On-System Assets<br><br>(Reference: page 13) | LDCs offer a virtual, nominated, cost-based peaking service to marketers serving daily metered customers, on an optional basis; and a no-notice, cost-based supplemental supply service serving non-daily metered customers. | These services provide added flexibility to marketers while retaining LDC control over the resources that support reliability and system integrity. |

| Design Element | Bay State Proposal | Reasoning |
|---|---|---|
| 7. Capacity Planning<br><br>(Reference: pages 13-14) | LDCs retain recontracting rights and obligations and may enter into new contracts, if necessary. These rights and obligations remain with the LDC until the market is adequately functioning to satisfy this need so that the Department could remove this obligation from LDCs; contracting decisions are subject to DTE approval | A central LDC role is necessary to ensure continued reliable service and to ensure that capacity is available for growth throughout the transition period. |
| 8. Transition Cost Mitigation<br><br>(Reference: pages 12-15) | Much of the potential stranded costs will be mitigated through system growth under the "75-75" approach, other detailed elements of the capacity assignment and planning process provide additional mitigation. | Transition costs, which are minimal under the "75-75" approach, are mitigated before the fact by the capacity planning approach, and after the fact by LDC optimization efforts. |
| 9. Transition Cost Recovery<br><br>(Reference: pages 15-19) | Marketers guarantee recovery of 75% of the costs associated with any unelected capacity. The remaining 25% of unmitigated costs will be borne by all customers. If the LDC is unable to mitigate up to 75%, transportation customers will pay a higher CTC. The impact on sales customers is less than 1% under all reasonable scenarios as shown in Table B-3. | All customers benefit from choice and the competitive environment that is created, even those that choose to remain with the LDC. Customers who remain as sales customers benefit from a more competitive environment that is created by Bay State's proposal, Customers who elect to return to the LDC should continue to bear a portion, however small, of the costs that fostered a competitive environment. |
| 10. Low-Income Program<br><br>(Reference: page 20) | The existing low-income discount is preserved and this market segment is offered the opportunity to choose a competitive retail marketer | Evidence from Bay State's pilot indicates that marketers are not excluding low income customers; enhancements may be necessary if this trend reverses itself. |
| 11. Customer Education<br><br>(Reference: page 20) | All LDCs implement a coordinated customer education plan, including government-sponsored efforts, prior to marketing by competitive suppliers, the costs of which are recovered through the Distribution Adjustment Cost Clause (DACC). | Pilot experience demonstrates that customers benefit from this sequencing of communications. |

# I. INTRODUCTION

Bay State is submitting comments independently of any other group of stakeholders because it provides a perspective that is unlikely to be provided by any other party to this proceeding. Bay State has gained considerable experience by offering choice to residential and small C&I customers during its two-year pilot program. The pilot program has been a substantial success from the perspective of the 27,000 participating customers, the 10 participating retail marketers and from Bay State's perspective. In addition, Bay State has benefited greatly from the opportunity to work collaboratively with other stakeholders to create a comprehensive approach to customer choice that would maximize the potential benefits for all customers, including smaller-volume residential and commercial customers.

These comments begin in Section II by addressing the importance of the development of a competitive retail gas market, recognized by the Department in its April 3, 1998 Notice of Inquiry as a primary objective of this proceeding. In order to realize this goal, a competitive market must be accessible on a fair basis to all customers, and the market must be attractive to potential retail marketers. In attempting to resolve the myriad of complex and interrelated issues that must be addressed to offer choice to small firm customers, it is easy to lose sight of this goal.

Bay State presents its own comprehensive proposal for offering customer choice in Section III. The role of the LDC during the transition period as a provider of services both to customers and marketers, assuming that Bay State's proposal is adopted, is described in Section IV.

The merits and limitations of alternative approaches to capacity related issues are presented in Section V which addresses the integrated issues of upstream capacity assignment, capacity planning, and capacity management. These issues must be addressed on an integrated basis because of the need to continue to provide reliable service to existing and potential new customers. Bay State's balanced approach to capacity assignment is discussed in this section. Section V also provides a discussion of the issues that must be resolved in order to provide marketers with the access to LNG and other local production assets that is essential to provide

reliable, reasonably-priced service to firm customers in this region of the country. Section VI discusses the portfolio auction approach, which affects the mechanics of a capacity assignment process although is not a necessary element of a customer choice program.

Section VII presents Bay State's assessment of the need for statutory and/or regulatory changes to implement natural gas customer choice in Massachusetts. Finally, a summary of proposed findings and recommendations is presented in Section VIII.

On April 10, 1998 the Department issued a set of supplemental discovery questions to the LDCs and other parties. Bay State's comments incorporate its response to questions 2-8 and question 10. Our response to question 1 is presented in Attachment B. Bay State's response to question 9 is provided as Attachment C.

Bay State welcomes the opportunity to answer any questions regarding its proposal from the Department and any other stakeholder at any time during the course of this proceeding.

## II. DEVELOPMENT OF A COMPETITIVE RETAIL GAS MARKET

The Department approved two Bay State pilot programs, in 1996 and 1997, which combine to offer choice to 100,000 residential and small commercial customers . The Department, in this proceeding, is establishing the framework for a competitive retail natural gas market that will be in place for these and all other Massachusetts customers for at least the next few years. This initial framework is critical if customer choice is to be viewed favorably by customers. In this section, Bay State comments on the challenge faced by the Department as it strives to reconcile the competing objectives of stakeholders, and to do so in a way that maximizes the likelihood that all customers will benefit from the new policy direction.

### 1. Creating a sufficiently competitive marketplace is necessary for all customers to benefit from choice.

In opening this NOI, the Department identified the development of a competitive retail gas market as its primary objective. Certainly, the Department recognizes that a competitive environment is a means to provide real benefits to customers and not an end in itself. Our experience with the two-year pilot program indicates that 86% of residential participants and 81% of C&I participants cited the ability to save money as the primary reason for selecting a competitive supplier. Moreover, their satisfaction with the pilot experience is dependent on their perception that they have been able to realize the savings that they had hoped for.[2]

Thus, one of the challenges in this proceeding is to not lose sight of this very basic goal as the Department sifts through the evidence and argument on the many detailed issues that must be addressed. Each and every policy decision should be tested against the anticipated contribution that it will make to the development of a competitive retail gas market. Moreover, the Department must also implement policies that assure that the benefits of competition are made

[2] Only 25% of residential participants were able to identify a perceived "shortfall" by their supplier – the shortfall most often cited (8% of customers) was that the price of gas was not as low as they expected.

available to all customers, and not just to a select few. It will be necessary to establish a process for evaluation and review of these policies to determine if, in fact, the anticipated benefits were borne out in the marketplace. It will also be necessary to perform this continual assessment and to reexamine the policies established in this proceeding as further evidence becomes available.

One question that should be answered before new policy is established is: Why are we doing this? This question has been asked by customers who have been eligible for our pilot programs, and will be asked by customers throughout Massachusetts before the end of the year. The industry, and all of its stakeholders, including the Department, must have a credible answer to this fundamental question if choice is to be introduced successfully and if the benefits of choice are to be realized as soon as is possible.

Bay State believes the answer to this question is that retail choice will bring more products and services to customers at competitive prices. However, unlike the electric industry, many of the wholesale natural gas market efficiencies have already been realized as a result of a series of FERC regulatory initiatives, culminating in Order No. 636. For example, as a result of its progressive gas supply procurement activities, Bay State's firm sales customers have already benefited significantly from competition in upstream supply, storage and interstate transportation markets. Nonetheless, extending competition from the city-gate to the burner-tip will result in a second wave of efficiency and innovation in the retail segment of the industry, which will lead to more gas purchasing options for customers, more products and services that they desire, and lower prices.

2. The competitive environment must be consistent with the expectations that are communicated to customers.

Customer communication plays a critical role in getting customer choice off to a good start. Bay State's experience with its pilot clearly supports the belief that a coordinated customer education and communication effort must be conducted as choice is introduced to natural gas customers.

This effort must set realistic expectations in order for choice to be viewed favorably by customers. Market research indicates that our eligible customers continue to have a high regard for Bay State Gas Company, as the satisfaction levels for residential and small C&I customers (and for participating and non-participating customers) ranged between 93-95% in the January 1998 research wave. This is at least partially attributable to the fact that our customer education and communication efforts, which indicated that the benefits from choice would soon be available, were consistent with the subsequent offers by marketers.

Bay State also believes that it is important to offer a real choice to all customers at this time. This will create an environment in which customers will view choice of suppliers as a quantifiable benefit, contributing to public acceptance of energy deregulation. It will also help maintain, if not improve, customer satisfaction through a period of considerable industry change.

3. Many customer choice objectives are potentially in conflict; the Department must find the appropriate balance.

The participants in the Bay State Customer Choice Collaborative recognized that although they shared the same high-level goals, the potential for conflicting objectives increased as the group began to address the issues on a more detailed level. Many of these conflicts result from the need to manage the transition from the current retail market structure to one that is a more competitive. In order to establish a framework for evaluating potential conflicts during the work of the collaborative, the stakeholders drafted a set of "Guiding Principles". These principles were submitted to the Department in Bay State's comments attached to the March 18, 1998 MGUC status report and are also presented in Attachment A to these comments.

The Department's order in this proceeding will essentially determine the manner in which these sometimes conflicting objectives will be balanced. Bay State believes that its proposal achieves the proper balance; other stakeholders will present their own views. In making the decision in this case, Bay State respectfully asks the Department to:

(1) identify the objectives for introducing choice, using the previously stated objectives and Bay State collaborative Guiding Principles as a basis;

(2) explicitly recognize the potential conflicts among competing objectives; and

(3) establish a process for continual assessment of the development of a competitive market.

Bay State urges the Department to adopt a broad view in evaluating each objective. Raising the level of any one objective to an "imperative" or "absolute" is likely to result in some loss of the ability to satisfy other objectives. Bay State's expression of this broad view takes the form of what we would like to be able to communicate to our residential and small C&I customers after the Department issues its final order. In summary, we think that it is important to communicate to our residential and small C&I customers that:

- they will continue to receive safe and reliable delivery of natural gas whether they choose a competitive supplier or elect to continue as an LDC sales customer;
- they will be able to choose from among many competing suppliers interested in competing for their business;
- suppliers will be able to offer them savings and other benefits;
- suppliers will also be offering new products and services, including alternative pricing and payment options;
- they will not be forced to choose an alternative supplier; the LDC will continue to remain a choice;
- they will not harm the LDC or be penalized by the LDC if they choose an alternative supplier;
- the LDC may also offer other products and services or new pricing options; and
- they will continue to benefit from existing customer protections.

If the new market structure is unlikely to result in these benefits, then customer satisfaction is likely to be adversely affected when choice is introduced.

The communication to medium and large C&I customers will be significantly different because these customers have had the ability to choose for several years. However, many of these customers have yet to take advantage of this opportunity. Therefore, the communication effort will need explain the changes that are being made and the potential impact on their evaluation of purchasing natural gas from an alternative supplier. In addition, customers who are already transporting or currently considering transportation may be substantially affected by the Department order. This will need to be communicated separately.

4. Other customer choice efforts provide some guidance to the Department, although the value may be limited by important regional differences.

The Department's April 10, 1998 request for additional information invited the parties to provide information on unbundling programs throughout the country. The Department's information request seeks data regarding customer eligibility, the customer enrollment processes (fixed vs. rolling), migration experience, capacity assignment, capacity renewal and additions, stranded costs including mitigation and cost responsibility, and overall impact of program design on the development of a competitive market.

Bay State notes that some caution must be applied in determining the applicability of this learning to Massachusetts. This concern was a driving force behind Bay State's decision to conduct its own pilot program. A principal concern from Bay State's perspective is the influence of the capacity supply/demand balance in the relevant market area on the design, and ultimately, on the success of many programs. The New England gas markets are both undersaturated (with strong competition from fuel oil in all market segments) and capacity-scarce when compared to other regions in the country. Bay State was also concerned that customer behavior and customer attitudes toward choice may not be transferable from other regions of the country to New England. Therefore, we believe that the most relevant experience, particularly if one is concerned about the ability of residential and small customers to benefit from choice, is Bay State's pilot.

In response to the Department's research request, Bay State is submitting the assessment of its own pilot program based on the Department's information request as Attachment C. As explained previously, Bay State believes that the experience gained during its pilot program is the most relevant available to the Department and other stakeholders in this proceeding. While Bay State has answered the questions asked of the Department in Attachment C, it also is prepared to offer additional summary materials or answer other questions concerning the learning available from Bay State's pilot.

## III. BAY STATE'S COMPREHENSIVE UNBUNDLING PROPOSAL

Bay State's comprehensive proposal is separated into four distinct but integrated areas: (1) the role of the LDC as a merchant provider; (2) capacity assignment, planning, and management; (3) transition cost recovery and responsibility; and (4) other important elements.

### A. Bay State's Proposal for Continuing to Provide a Utility Sales Service

Bay State's pilot experience supports the view that, at this time, many customers are either not interested in choice or "not sure" at this time. In addition, many customers who have chosen an alternative supplier have benefited from the existence of the Bay State sales service as their marketers offered discounts off the Bay State price. In this case, the cost-based Bay State alternative is contributing to the benefits provided by a competitive market without hindering the development of that market. Therefore, Bay State believes that LDCs should continue to offer a Utility Sales Service until it is clear that it no longer meets a market need. After some experience is gained, the Department may deem it appropriate to allow the LDC to offer enhancements to the regulated sales service (e.g., a fixed price option) if market research indicates that a significant portion of customers continue to prefer an LDC service.

Bay State has also expressed its concern that retail marketers will focus their initial efforts on existing customers and customer loads, and that beneficial growth in throughput will suffer during the transition period if the LDC does not continue to aggressively pursue opportunities to add load. These objectives are summarized in the first five elements of Bay State's proposal.

1. **Utility Sales Service ("USS"):** The LDC would continue to offer a regulated merchant service both to existing and new customers. Residential and small C&I customers who had been taking service from a competitive supplier, but wished to return to USS, would be allowed to do so at any time. Medium and large C&I customers would be allowed to return to USS during the non-winter months, but

would return to Temporary Sales Service ("TSS") during the winter. Medium and large C&I customers who are receiving TSS at the end of the winter season would be transferred to USS at that time.

***Reasoning:*** Continuing to offer a sales service allows customers to choose an alternative supplier when they perceive an advantage in doing so. Bay State's pilot indicates that the continued LDC sales option has not had an adverse impact on the development of a competitive market environment. Customers who choose an alternative supplier are doing so because they perceive real benefits. Allowing smaller customers to return to this service also contributes to customer satisfaction by making choice "friendlier," by retaining a high quality gas supply alternative that suppliers must continue to compete against, and by encouraging more customers to "try" choice without giving up the ability to return to USS. Cost-based gas supply pricing of USS avoids subsidies among customer classes and reflects the competitive marketplace, which allows suppliers to attract customers in all rate classes. Cost-based gas supply pricing makes the residential and small C& heating and non-heating markets equally viable.

2. **LDC Exit from the Merchant Function:** The Department should not establish a date for an LDC exit from the merchant function at this time. This decision should be based on actual experience with customer choice and evidence which suggests that an exit is viable and appropriate. The experience may include further testing of alternative approaches to satisfying the provider of last resort requirement.

   **Reasoning:** Bay State has consistently supported a "reasoned approach" to the potential exiting of the merchant function by LDCs and has opposed the establishment of a date certain for an LDC exit of the merchant function until the Department can evaluate the experience gained as a result of the new policies to be established in this proceeding. The Department does not have the evidence which it needs to conclude that mandating an exit from the merchant function is in the public

interest. It is simply not possible to make this determination in advance of an assessment of customer behavior and attitudes based on an environment in which they have a broad array of choices. Moreover, there is no benefit to establishing a date at this time. This issue can and should be revisited after at least two years of actual experience and/or as decisions with respect to major capacity contract renewals are made. At that time, the Department may have the information that it needs to determine whether a mandated exit is appropriate, and if so, to establish the timing and approach to a merchant function exit that is likely to be most beneficial to customers. The evidence that should be gathered during this period includes customer migration by market segment, customer benefits, customer satisfaction, marketer participation, the degree and source of resistance to choosing an alternative supplier by market segment, the relevance of a continued LDC service or even LDC enhanced services to the development of a competitive market, pilot tests or experience in other jurisdictions which attempt to address concerns over the supplier of last resort issues, and other relevant information that can only be gathered under conditions in which customers already have choice.

3. **Portfolio Outsourcing:** LDCs may outsource the city-gate supply service provided to its USS customers but are not required to do so.

   **Reasoning:** The outsourcing of an LDC's portfolio as a result of an auction or competitive negotiation is not necessarily related to unbundling. Nonetheless, it may provide opportunities for LDCs to provide the USS more efficiently and should therefore remain a viable option. It should not be mandated as part of an unbundling proceeding and applied to all LDCs because it may not lead in every case to savings that more than offset the costs of implementing the option and compensating the asset manager (which includes internal costs as well as fees charged by the asset manager). Thus, outsourcing of the portfolio should remain an option, but should only be elected if the likely savings exceed the incremental costs of implementing this option. Any shifting of portfolio risk from the asset manager to the LDC and its customers would also have to be evaluated. ***This issue is discussed in detail in Section VI.***

4. **Temporary Sales Service:** LDCs would allow medium and large C&I customers to return to USS during the April-October season, but would require them to return to a higher priced TSS during the winter season which reflects costs above an LDC's base load level of resources.

   ***Reasoning:*** An individual small customer can return to USS without any significant impact on gas supply costs; the return of medium and large C&I customers during the winter period will most likely require the LDC to acquire more expensive supplies than are reflected in their seasonal planning. If a trend develops in which large numbers of small customers are returning to sales service, then this issue may need to be revisited.

5. **Utility Marketing:** LDCs would continue aggressive marketing to attract new customers and encourage existing customers to add new end-uses, but would work cooperatively with suppliers and advise customers of potential additional benefits available by purchasing from an alternative supplier.

   ***Reasoning:*** Growth in throughput will not be sacrificed as suppliers are likely to focus their attention on existing customers. Meanwhile, the LDC and suppliers would be developing and testing partnering models for working together to attract new load that will serve as the basis for long-term continued growth. Hopefully, further market testing will result in evidence that marketers will pursue new load opportunities. Continued growth provides for more efficient utilization of an LDC's distribution system which benefits all customers by reducing the cost of service.

B. Bay State's Capacity Assignment, Planning and Management Proposal

Through its successful pilot programs and extensive collaborative discussions on capacity assignment principles and issues, Bay State has developed a capacity assignment proposal that will meet the objective of fostering viable competition as soon as practicable, while also providing an orderly transition to an environment in which all customers benefit from choice. Because of the collaborative discussions that led to its development, the proposal presents a balance of the many conflicting objectives and competing interests while providing quantifiable benefits to customers from choice both in the short-term and longer term. While it preserves the existing right of LDCs to recover prudently incurred capacity-related costs associated with past capacity decisions, the retention of an LDC role in capacity planning places the LDC at some risk with respect to future capacity decisions.

The key elements of Bay State's proposal and a summary of the reasoning is presented in the following paragraphs. ***A more detailed discussion of merits and limitations of alternative approaches is presented in Section V.***

1. **Upstream Pipeline and Storage Capacity Assignment:** Bay State is proposing an integrated "75-75" approach to the complex issues of capacity assignment and allocation of stranded costs. Under this proposal, at the outset suppliers are automatically assigned 75% of their pool's pipeline and storage capacity requirements and may select up to 100% of their pool's requirements. Capacity not elected by a supplier at the time it is initially offered would not be offered to them in subsequent years. The LDC would select paths which provide operating efficiencies to marketers and price all capacity at the system average (or divisional average, if appropriate) in order to preserve equity between sales and transportation customers. The total capacity available and therefore subject to the "75-75" formula will be reduced if and when the LDC elects not to renew existing capacity contracts.[3] Assignments would be year-to-year with limited recall rights in the event of supplier non-performance or loss of load. This approach represents a hybrid between voluntary and mandatory assignment. As explained in the next subsection addressing transition cost recovery, firm transportation customers will also be allocated all transition costs up to 75% of the value of any unelected capacity. Through this second component of the "75-75"

[3] Contract renewal decisions are made after consultations with marketers and Department review and approval (see "Capacity Planning" discussion).

proposal, retail marketers are effectively providing a guarantee that the LDC will recover at least 75% of the value of unelected capacity from the transporting customers.

***Reasoning:*** The "75-75" capacity assignment approach provides a balance of the varied positions in the capacity debate. This proposal responds to Bay State's second year pilot experience in which only 59% of the capacity made available to suppliers was elected. Assigning 75% of a supplier's capacity minimizes almost all of the potential for stranded capacity. Even if suppliers did not elect any of the remaining capacity, a significant amount of the unelected capacity would be used for system growth, offsetting the need to acquire incremental resources. Bay State estimates that it could accommodate migration from sales to transportation service of approximately 10% per year initially without creating any stranded costs under its "75-75" proposal. The flexibility to obtain their own sources of capacity of up to 25% of a pool's requirements at the outset offers suppliers the ability to deliver benefits for customers by reducing portfolio costs. The selection of paths also helps marketers manage the capacity that is assigned to them. Over time, suppliers will be able to increase the proportion of capacity that they are able to self-source, if the LDC does not renew contracts or is able to capitalize on anticipated opportunities to assign capacity to emerging markets.

2. **Access to On-System Peaking Assets:** Suppliers serving non-daily metered customers would be provided access to the LDC's LNG facilities on a "virtual" basis, having injections made on their behalf by the LDC but nominating withdrawals on a daily basis much as they do with their upstream storage providers. This service would be priced at cost until such time as the market is determined to be competitive. Daily-metered customers or their suppliers, who are responsible for balancing, would be offered a similarly structured "virtual" peaking service supported by all peaking resources including LNG, LP and other contractual arrangements that provide a peaking supply.

   ***Reasoning:*** Suppliers receive all the economic benefits of access to local production facilities that they need, while the LDC continues to operate (i.e., schedule, inject and withdraw liquids) and maintain the facilities. In contrast, providing actual access at this time (which implies at a minimum that marketers would be responsible for scheduling and delivering their own supplies to the LDC's facilities), would require the LDC and marketers to address a series of complex and costly operational and management issues.

3. **Capacity Planning and Ongoing Regulatory Review of Capacity Decisions:** The LDC would retain the renewal rights for all capacity released to suppliers and would acquire incremental capacity to meet future load growth in the event that it is necessary to do so. The LDC would consult with retail marketers that are active on their system prior to the time of exercising any right to renew existing capacity or

acquire new capacity. After consultation, the LDC would file a request with the Department to either renew or relinquish any significant capacity resources.[4] The filing would indicate the extent to which the request is supported by marketers on its system as well as other stakeholders. The LDC will also provide forecasted load and supply information (identifying supply being provided by retail marketers) sufficient to support the request.[5] For capacity that the LDC elects not to renew, the LDC will offer the renewal rights to suppliers doing business on its system.

In addition, the LDC would maintain a "Transition Insurance Pool" to ensure that capacity exists to facilitate customer switching from suppliers that had not elected 100% of the LDC capacity made available to them either to other suppliers that desire 100% of that capacity or return to the LDC USS. This pool of capacity, which would be set at a percentage of capacity not elected by suppliers, would also be used by the LDC to provide Temporary Sales Service to larger customers who are caught between marketers during the winter season. The Transition Insurance Pool would also ensure that capacity is available in the event of supplier non-performance.

***Reasoning:*** A continued LDC role is necessary during the transition period and until such time as it is clear that a market or other mechanism is ensuring that capacity will be available to reliably serve firm customers on a daily, seasonal and long-term basis. The Transition Insurance Pool would be a low-cost means to provide for a more fluid market and would avoid the undesirable need to erect barriers to customers who desire to switch suppliers.

4. **Capacity Management:** The LDC will continue to be responsible for optimizing the utilization of assets in its portfolio to serve remaining sales customers.[6] Additionally, the LDC will perform a similar function related to any unelected capacity associated with transportation customer loads. The LDC will continue to access the broadest array of markets to provide the maximum benefit for customers through reductions in portfolio costs and sell any unutilized capacity to on-system interruptible markets, off-system bundled sales markets and capacity release markets in order to maximize the value of that capacity. Additionally, the LDC will enter into agreements with asset managers to manage its unelected capacity if the net benefits of doing so exceed those

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[4] "Significant" would be defined as a certain threshold; Bay State proposes that this threshold be set at the greater of 5,000 dth/d or 5% of peak day requirements.

[5] The precise information and format will be established in regulations that would supercede the existing forecast and supply plan regulations. LDCs would only file this information when seeking the review of a specific contracting decision.

[6] Revenues attributable to capacity management associated with the sales service portfolio will be allocated between customers and the LDC and among classes of customers based on existing revenue sharing mechanisms.

the LDC can generate on its own. Revenues attributable to management of unelected capacity will be credited to the Capacity Transition Charge ("CTC").

***Reasoning:*** The LDC should remain responsible for optimizing the portfolio that serves its customers. The LDC should also pursue aggressive management of unelected capacity to reduce the level of the CTC.

C. Bay State's Proposal for Recovering Potential Transition Costs

The two transition cost issues to be resolved by the Department are (1) the ability of LDCs to recover transition costs, and (2) the allocation of those costs among customers. These issues are addressed sequentially in this section.

1. The LDC is entitled to recover all transition costs that are associated with prudently incurred commitments.

The Department's regulation of LDCs planning and procurement of gas supply and transportation resources and related cost recovery is pervasive in support of this conclusion.

The Department reviews LDCs' plans to ensure the availability of "a necessary energy supply for the Commonwealth with a minimum impact on the environment at the lowest possible cost."[7] Periodically, every LDC must file a long-range forecast with respect to the gas requirements in its market area.[8] In this filing, the LDC must demonstrate "that the application of its supply planning process, including adequate consideration of DSM and consideration of all resource options on an equal basis, has resulted in the addition of resource options that contribute to a least-cost supply plan."[9]

[7] M.G.L.A. c. 164, §69H.

[8] M.G.L.A. c. 164, §69I.

[9] Bay State Gas Company, D.P.U. 93-129 pp. 44-45 (1996).

Pre-approval by the Department is required for all gas supply contracts which exceed one year.[10] The prudence of the decision to enter a supply contract is based on information available at the time the decision was made.[11] The utility has an obligation to manage contracts and to react appropriately to changing circumstances.[12]

The Department has consistently recognized that prudently incurred costs are fully recoverable from customers, stating that, "[u]nder fundamental ratemaking principles, derived from statutory and constitutional requirements, a utility is entitled to recover reasonable and prudently incurred costs…".[13] Department policy also states that if the utility manages the gas supply contracts prudently, it may recover the costs associated with such contracts.[14]

Recovery of gas costs has been accomplished principally through use of a Cost of Gas Adjustment Clause ("CGA"), a reconciling mechanism that provides for the collection of all costs and of carrying charges on amounts under or over collected in any given period. Semi-annually, the Department allows LDCs to adjust rates to reflect variations in the cost of gas.[15] The Department has allowed gas cost related items to be recovered through the CGA, recognizing that this method enables companies to more accurately collect costs in the context of uncertainty.[16]

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[10] M.G.L.A. c. 164, §94A.

[11] Berkshire Gas Company, D.P.U. 93-187/188/189/190, p. 15 (1994).

[12] Id.

[13] Western Massachusetts Electric Company, D.P.U. 91-290, pp.7-8 (1992)

[14] Berkshire Gas Company, D.P.U. 93-187/188/189/190, at 15-16.

[15] 220 CMR 6.01.

[16] Colonial Gas Co., D.P.U. 90-90, p. 66 (1990); Bay State Gas Company, D.P.U. 97-97, (1997) (bad debt expense associated with gas costs allowed through the CGA); Boston Gas Co., D.P.U. 88-67, pp. 40-41 (1988)(working capital requirements on gas costs allowed through the CGA).

Bay State's unbundling proposal, consistent with Department policy, provides for full recovery of prudently incurred capacity costs.

2. It is appropriate to allocate a diminimus level of transition costs to customers who elect to defer choosing a competitive supplier until some future date.

Bay State proposes to recover any transition costs that remain, after application of its "75-75" capacity assignment proposal, equally among all customers, including those customers who have not yet elected an alternative supplier. Specifically, under Bay State's proposal, suppliers are required to elect a minimum of 75% of the capacity allocated to their customer pools. Capacity that is unelected will be mitigated by the LDC. If the LDC receives less than 75% of the cost of the unelected capacity, transportation customers will be assessed a Competitive Transition Charge ("CTC") collecting the difference up to 75% of the cost of the capacity. The remaining 25% of transition costs that need to be recovered will be charged to all customers. In this case, the CTC for transportation customers will be higher than the corresponding CTC paid by sales customers. If the LDC receives more than 75% of the cost of the capacity through its mitigation efforts, transportation and sales customers will pay an identical CTC. Bay State proposes that the CTC be calculated on an annual forecasted basis and trued up on an annual basis, with semi-annual adjustments to reflect the most recent experience.

The resulting CTC , as shown in the response to the Department's request for information, No. 1 (Attachment B) is diminimus for remaining sales customers under Bay State's proposal. This approach is consistent with Department policy, as discussed in the following paragraphs. There are numerous instances where, to accomplish a broader policy goal, the Department has explicitly allocated costs to customer groups or classes that benefited indirectly rather than directly from the Department's goal.

It is informative to review the benefits provided to customers under Bay State's unbundling proposal to provide the appropriate context for discussing the cost responsibility issue. Customers who choose an alternative supplier receive a direct and immediate benefit from

customer choice. However, even customers who defer their selection of an alternative supplier (by electing to continue to receive sales service from the LDC) benefit significantly from the competitive environment created by choice and from ability to choose. Specifically, they benefit from the "bar" set by the LDC continuing to offer a regulated sales service, and from the more timely development of a thriving competitive market that will be there to serve them when they are ready. Bay State's proposal to allocate a diminimus portion of transition costs to these customers represents an investment of less than 1% (see Table B-3) for an opportunity for potential future 7-13% savings (as experienced in the Bay State pilot). This is an investment that Bay State believes should be made, particularly if failure to make that investment will impede the development of a competitive market.

**This is also consistent with the view that costs associated with the transition to a competitive market should be borne by the customers who benefit in proportion to the benefits which they receive. Thus, based on the facts that are presented, it may be appropriate to allocate a large share of transition costs to early migrators but it would be inappropriate to allocate 100% of such costs to these customers if it can be demonstrated that late migrators also benefit. The latter is clearly true in this case. In contrast, if costs are allocated in a manner that makes it difficult for retail marketers to offer savings to customers, then the development of the market and benefits that would have been realized by customers who are ready for choice will be lost.**

Turning to Department policy which supports Bay State's proposal, perhaps the clearest example is the Department's policy for selecting and recovering costs associated with demand side management (DSM) programs. The Department has rejected the "no-losers test" for supply planning purposes.[17] In rejecting such a test, the Department clearly allowed some ratepayers to incur higher immediate costs (i.e., be losers) in order to capture the long-term benefits of DSM for the entire system. In reviewing DSM program designs, the Department requires LDCs to

[17] Under the no-losers test, if anyone would immediately face a higher cost, the DSM proposal would be rejected (i.e., not offered to any customer). Bay State Gas Co., D.P.U. 91-272, p. 5 (1992).

minimize, where possible, but certainly not eliminate, rate impacts on customers who chose not to participate in the program. In situations where adverse rate impacts exist, the Department seeks cost allocations that "reduce the rate impacts to more acceptable levels."[18] The Department has explicitly stated that "because all ratepayers benefit to some extent from C&LM programs, ... it would not be equitable to allocate C&LM costs only to program participants."[19]

Similarly, the Department has consistently approved subsidized rates for low-income individuals with the resulting revenue shortfall being allocated to other customers. The Department approves such programs as long as "the impact of the subsidy on nonparticipants is reasonable."[20] The Department is willing to have non-participants fund a program that produces benefits for society, assuming the impact on non-participants is reasonable.[21]

The Department's specific regulations prohibiting utilities from terminating service to the elderly and other qualifying customers who face financial hardship gives rise to another instance where certain customers bear an allocation of costs to achieve a social benefit that they do not share.[22] Specifically, if a hardship customer or someone living in such a customer's home is seriously ill, or there is a child under the age of one year living in the home, the customer's utility service may not be shut-off between November 15 and March 15, due to the customer's failure to pay.[23] Likewise, utilities may not shut off service to households for nonpayment where all residents are over the age of 65 unless the utility first obtains the approval of the Department.[24] These protections, undoubtedly increase an LDCs bad debt expense, which the Department allows to be

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[18] Id, at 380.

[19] Boston Gas Company, D.P.U. 90-320, pp. 101-102 (1992).

[20] Western Massachusetts Electric Company, D.P.U. 87-260, p. 177 (emphasis added).

[21] Bay State Gas Company, D.P.U. 92-111 (1992); Western Massachusetts Electric Company, D.P.U. 87-260, p. 177 (1988).

[22] 220 CMR 25.03, 25.05

[23] 220 CMR 25.03 (1)

[24] 220 CMR 25.05 (3)

recovered from other customers.[25] Thus, customers who pay their bills regularly subsidize these bad debts in order to achieve the larger social benefit of continuing essential services during the heating season to the elderly and to segments of the customer base that may not be able to pay for their own utility services.

In summary, Bay State Gas' capacity assignment proposal is appropriate and is consistent with Department precedent.

[25] Bay State Gas Company, D.P.U. 92-111 (1992), pp. 166-167.

D. Other Elements of Bay State's Comprehensive Unbundling Proposal

Other aspects of a comprehensive program that are not described above, or otherwise anticipated to be addressed by the MGUC discussions on terms and conditions include:

- A coordinated approach to customer education and communications. Bay State's pilot experience demonstrates the importance of an aggressive, utility-sponsored customer education effort that precedes, and provides a foundation for, suppliers' marketing communications by addressing customers' uncertainties and concerns related to supplier choice and unbundling;

- Recognition of the need to transition the Commonwealth's existing transportation customers, including Bay State's 27,000 pilot customers, to new tariffs without creating a negative experience for these customers; and

- A commitment to low-income and fuel assistance customers to maintain existing subsidies and adjust administrative processes as necessary to allow them to purchase their commodity from a competitive supplier.

## IV. THE ROLE OF THE LDC DURING THE TRANSITION PERIOD

It is useful to focus on the critical and evolving role of the LDC during the transition period, in order to understand and assess alternative proposals, including Bay State's proposal presented in the preceding section. The Department's order in this proceeding will essentially define this role. This is most apparent when considering the approach to capacity assignment, planning and management as it needs to reflect the evolving role of the LDC as customers migrate from sales to transportation service. It is no longer possible or appropriate for the LDC to perform many of its functions independently of the retail marketers that are also serving customers. The roles served by the LDC, if the Department were to adopt Bay State's proposal, are described below:

**Merchant Provider:** Bay State's pilot experience indicates that the LDC should continue to offer a regulated sales service to all of its customers along with the choice to select service from qualified retail suppliers. Customers will view choice more favorably if the LDC remains a choice and they are not forced to elect an alternative supplier before they are ready. This will require the LDC to continue to hold capacity and optimize its portfolio, with constant changes over time as customers migrate to transportation service. Management of the portfolio may be accomplished through an asset management relationship with a wholesale gas marketer or other entity, although customer migration will make this a more complicated process than it has been over the past few years.

**Provider of Last Resort:** The LDC will continue to assume this role until the Department determines that the function is no longer needed or can be provided more efficiently by another entity. Currently, no market mechanism is sufficiently mature to serve this role. Greater commitment on the part of competitive suppliers to small volume retail markets is needed before alternatives to the LDC as the provider of last resort can be studied and tested. In fact, more recent experience indicates that there may be less interest among marketers in the small volume markets, making it necessary to for LDCs to provide customers with this service.

**Upstream Asset Assignment:** To ensure an orderly transition, it is critical that the retail suppliers have access to the upstream assets that the LDC had been using to supply the marketers' customers. The LDC must transfer resources from its own portfolio to that of a retail supplier acquiring its customers and the LDC must retain the right to recall capacity in instances when a customer switches to another supplier or returns to the LDC.

**Capacity Contracting:** The LDC must play a significant role in capacity renewal and incremental capacity decisions for its markets, especially at the outset of the transition period. No entity other than the LDC is presently able to manage capacity renewal rights and intervene in capacity markets in order to ensure new capacity is developed.

Naturally, this will necessitate that the LDC is appropriately remunerated for the costs and risks of doing so, after appropriate regulatory review. However, depending on how the market develops, the LDC may not need to control the same amount of capacity as it has in the past. Wherever possible, the LDC should relinquish its role to competitive markets in order to stimulate greater efficiency and innovation. This can be accomplished through market monitoring, planning, and interaction with stakeholders and responding based on known circumstances.

**Peaking Service Provider:** The LDC's investment in peak-shaving facilities is put to best use as customers migrate to transportation service by offering retail suppliers peaking and balancing services that mirror, to some degree, the manner in which the LDC relied on the same resources to provide bundled sales service. These facilities should also be used to develop new market-responsive offerings to marketers as their needs evolve in the future. Because of the critical role that these facilities play in maintaining distribution system pressures during cold periods as well as the facilities' operational characteristics, it is necessary that the LDC continue to control their operation and utilization.

**System Balancing:** Assuring that customers are always able to get the gas that they have purchased requires constant monitoring and supervision of the gas distribution network. It also requires that the LDC have available gas supply resources to respond to deliveries of gas by suppliers that are either higher or lower than expected on a daily basis, or even within the day, and thus maintaining a balance between demand and supply on a system-wide basis.

**Load Growth:** The LDC must retain the ability to plan the expansion of its system and procure the capacity and supply necessary to meet the growth in system loads. Although some system load growth may be supplied by retail marketers, the LDC must assure deliverability and appropriate integration into peak day planning, system balancing and other needs.

**Peak Day Planning:** Ensuring the reliability of peak day gas supplies not only involves the management of upstream capacity resources, but entails significant investment and operation in peak-shaving facilities within the LDC's service territory. It is worth emphasizing that peak-shaving facilities represent nearly half of Bay State's peak day deliverability. The LDC should continue to plan for and operate these facilities to ensure that sufficient capacity exists and that they are available when needed to meet colder conditions often experienced in the Northeast.

With the continued involvement in each of the facets of capacity acquisition and management, the LDC will continue to be subject to Department oversight. Naturally, the degree of oversight and regulatory process will change to meet the needs of a competitive environment.

The Department must determine if this is the role that it contemplates for the LDC, at least during the transition period. Bay State provides additional support for the aspects that are related to capacity assignment, planning and management in the following section.

## V. DISCUSSION OF CAPACITY ASSIGNMENT, PLANNING AND MANAGEMENT

Prior to examining the capacity issues in detail, it is appropriate to identify general goals to guide the development of policy for this most important and complex facet of the unbundling process. Bay State proposes the following objectives based on the learning that has occurred through its customer choice programs as well as through its customer choice collaboratives which involved a broad array of stakeholders:

1. Ensure the continued reliability of gas service by making certain that existing and potential new customers have access to adequate capacity today and in the future;

2. Provide suppliers with ready access to existing capacity resources on reasonable terms;

3. Afford LDCs with the opportunity to continue to cost-effectively acquire and manage a portfolio necessary to provide a regulated supply service to those customers who desire and choose it, and to support transportation services through operational balancing and other means;

4. Seek to maximize the value of available assets on an annual, seasonal and day-to-day basis through aggressive capacity management activities;

1. Over time, shift the responsibility and risk associated with acquiring and maintaining capacity resources to the competitive market commensurate with the ability for the competitive market to maintain reliability and providing capacity to grow; and

2. Provide suppliers with access to downstream assets to enable them to develop and manage efficient portfolios.

1. The issues of capacity assignment, planning and management must be considered together during the transition period.

The portfolio decisions made by LDCs reflect the need to satisfy reliability requirements at the lowest reasonable cost (capacity planning) as well as the maximization of value from the assets after they have been acquired (capacity management). These objectives have always been closely related and will continue to be as long as LDCs remain responsible for providing a merchant service to customers, maintaining the role as the provider of last resort, providing system balancing and meeting all other operational requirements. This will be true even if the LDC elects to outsource its supply service. Retail marketers will approach capacity acquisition and management in a similar manner although their portfolios will be optimized to meet the needs of their pools of customers.

During the transition period, there needs to be close coordination between LDCs and retail marketers on capacity-related issues in order to ensure that reliability of service is maintained and to enable both the LDC and retail marketer to construct and maintain "efficient" portfolios. In addition, capacity must be made available to serve load growth. As upstream pipeline capacity is generally associated with specific city-gate delivery points (unlike the electric industry which has a regional capacity market), it makes sense for both LDCs and retail marketers to develop an efficient way to transfer city-gate delivery capacity from LDCs to retail marketers as customers migrate from sales to transportation service.

Retail marketers also need the ability to efficiently utilize gas supply assets most effectively as it is a primary source of competitive advantage in an unbundled environment. This competitive advantage, which derives from a combination of scale, innovation and asset management capabilities, is a desirable outcome of a competitive market that will lead to longer-term customer benefits. Moreover, the ability of retail marketers to provide a city-gate service at a total lower delivered cost and to deliver new product offerings for customers is almost entirely a function of the marketers' ability to acquire and manage upstream assets. The competitive gas commodity market makes it difficult for them to derive any advantage in purchasing natural gas unless they are willing to assume market risk.

Capacity planning is of particular importance during the transition period. Without continued development and acquisition of assets through long-range capacity planning activities, sufficient capacity may not be available to assign to suppliers or to meet new load growth, and capacity markets in certain areas may experience price spikes and capacity shortages. The relatively recent restructuring of interstate capacity markets has increased the efficiency and utilization of these assets, but has not yet resulted in new capacity being developed to serve New England although several projects, including PNGTS and Maritimes, are making substantial progress. LDCs must continue to play a role in ensuring that capacity is dedicated to their market area until such time as market forces can be relied on to satisfy this need.

The transition period is also critical because so much is uncertain regarding the development of retail markets including the interest of customers in natural gas choice, the impact of electric choice, the identity of marketers, the holders of capacity to the region, the FERC regulations that define the terms under which capacity is held, and other important factors. All this requires an approach to capacity assignment, planning and management that recognizes the transitional nature of these markets.

2. The reliability of service must be maintained throughout the transition period

One of the most important roles of the LDC is to ensure supply and distribution system reliability. An important component of maintaining reliability is ensuring adequate capacity exists upstream of the distribution system. Furthermore, reliability must be maintained on a daily, seasonal and annual basis. With the introduction of competition, the transfer of any degree of control of capacity resources and the associated role for ensuring reliability must be completed in a manner that will maintain the reliability of supply and the distribution system that delivers that supply to customers.

The Department has traditionally served an important oversight role in ensuring reliability, primarily through its review of LDC forecast and supply plans. The investment and contracting decisions made by LDCs in order to meet the reliability standards established by the Department

frequently require an LDC to make a long-term financial commitment to a pipeline or other upstream service provider. If the resource is a new project development effort, the lead time necessary to place incremental capacity in service is usually three to five years. Although the secondary capacity markets have become more liquid since FERC Order No. 636, access to primary delivery point capacity to the LDC's city gates is still needed to serve firm markets. The heavy financial commitments and long lead times necessitate a formal planning process. LDCs have traditionally projected demand at least five years out into the future in order that resources can be acquired and placed in service cost-effectively. Additionally, LDCs incorporate a reserve margin into their capacity planning to accommodate extreme or unexpected conditions. Lastly, acquisition of capacity for firm markets is done on a primary delivery point basis so that it can be relied upon under all operating conditions.

Reliability also requires the LDC to balance the system by responding to demand which fluctuates on a daily and hourly basis, requiring the LDC to perform a number of important gas supply operations to accomplish this end. The first is to forecast requirements for the upcoming day and following few days accurately and to schedule resources to ensure adequate resources are available. Additionally, unpredicted swings due to weather changes and other factors must be met by calling on resources that the LDC plans to have available on a daily basis for these purposes.[26] While the LDC is ensuring the daily reliability of its resources, it also seeks to increase their utilization in order to maximize potential economic benefits. The challenges of responding to these demand changes increases as a more competitive market evolves, in part simply because more marketers are bringing gas into the LDC's system.

The retail supplier's approach to reliability is different from that of an LDC. The retail supplier commits to providing reliable service to its customers through direct contractual provisions and its desire to acquire and retain firm customers. The retail suppliers can reasonably be expected to provide the level of reliable service desired by typical firm customers over the short term. Additionally, so long as penalties and ancillary services are structured properly, the retail supplier

[26] For this reason, Bay State proposes that LDCs offer a balancing service to non-daily metered pools.

faces similar economic consequences to the LDC for failure to maintain reliability, which should provide it with the appropriate incentive to dedicate necessary capacity resources to its markets.

While both the retail supplier and the LDC each have incentives to provide for reliable supply to serve their customers over the short term, the nature of the incentives are fundamentally different. LDCs serve customers in a monopoly franchise territory pursuant to a regulatory compact that does not allow withdrawing from a market at some future time. On the other hand, retail suppliers' incentives flow from contractual relationships with their customers, and in most cases, LDCs as well. The duration of a retail supplier's commitments are typically one year, sometimes more, sometimes less. The nature of these relationships will also continue to evolve as the competitive market grows. Once its commitments have been satisfied, a retail supplier can choose not to serve a particular market or fold up shop altogether if market conditions are undesirable. In fact, competition will require successful retail suppliers to respond quickly to changing conditions and maximize the benefits of participation in particular markets while potentially avoiding other markets.

The prudent means of addressing this critical challenge is to design and implement a transition of the LDC's responsibility for ensuring reliability to the marketplace as alternative suppliers demonstrate a permanent capability to assume this role. Bay State has developed and presented a proposal to involve retail marketers in critical capacity decisions and to seek Department review and approval of those decisions. To prevent LDCs from acquiring any new resources or to cause them to relinquish all of their existing capacity renewal rights to retail suppliers not only prevents an LDC from meeting its customers' needs, but subjects firm customers to undesirable risks as a result. Nevertheless, failure to begin a reasoned transition of responsibility to the marketplace, where it is possible today, will stunt the market development and ability to generate benefits. Achieving balance is critical and requires a clear understanding of the policy implications involved. The approach advocated by Bay State is an appropriately cautious one that still achieves the goal of stimulating the development of a competitive market.

3. The LDC must continue to play a central role in capacity planning.

The overreaching objective for a transitional approach to capacity planning is that markets continue to be assured that capacity is available when needed. Although capacity markets themselves will respond to demand by supplying needed capacity, these markets are not fluid due to the significant capital requirements, regulated returns and general lumpiness of investments. The need for intervention by the LDC will not change as a result of the development of retail competition. The three primary reasons for active involvement in capacity markets are:

1. Ensuring the overall reliability of capacity for existing customers;
2. Protecting customers from harm that may result from supplier non-performance for customers who migrate to transportation; and
3. Providing for growth.

In a practical sense, capacity planning involves two separate matters. The first is providing for the ongoing daily and annual operation of the system and is process-oriented. Elements of this operational aspect include the implementation of any needed safeguards in the capacity assignment process and protecting against short-term market failures. The second aspect is associated with capacity contracting decisions that have longer term implications. These decisions include whether to renew existing capacity or contract for new capacity and typically involve significant financial commitments that can affect market efficiency in a local area.

As an LDC's capacity is acquired by suppliers through any capacity assignment mechanism, safeguards are necessary to ensure that the capacity remains dedicated to the LDC's market area. This is accomplished fairly easily by placing limited recall provisions on the assignment that allow the LDC to reacquire the capacity from the retail supplier in the event customers return to the LDC or switch to another supplier.

Additionally, all customers require protection against potential situations of non-performance by one or more suppliers. The Company will need access to capacity resources to cover these situations; however, it is unlikely that all suppliers will be unable to perform at the same time. Therefore, it is not necessary to retain duplicative capacity but some level of insurance capacity is

needed. An insurance pool can be structured to cover a portion of the capacity that suppliers elect to acquire from sources other than the LDC as long as the LDC retains the right to recall capacity from suppliers who experience performance difficulties.

The approach to longer term capacity decisions, including both capacity renewal and incremental capacity decisions needs to reflect the state of the wholesale and retail markets at the time each decision will be made. Relevant information includes the degree of customer migration, the general operation of the evolving wholesale markets, the longer-term performance of retail suppliers, the regional supply-demand balance, the level of growth being experienced and the role of third-parties such as intermediaries or financial markets in stimulating new capacity projects. Each of these factors is likely to change significantly over the next three to five years during which time important capacity decisions will need to be made.

At the outset of the transition period, it is clear that the decision to renew existing capacity must be made by the LDC, based on the state of market development. An absolute requirement that capacity renewal rights for existing capacity remain with the LDC is needed even as the LDC's bundled market diminishes. Renewal rights will help bridge the gap between the long-term nature of capacity markets and the shorter-term perspective of retail suppliers. Renewal rights should be retained to preserve the option of exercising them in the future at the time that a decision must be made. There is no value in giving up this right before more information is available to make a proper assessment of the value of renewal rights. The process for making this decision and the regulatory oversight involved must change to be consistent with the development of the market at the time the decision is made. In particular, the LDC must deliberately assess the commitments, desires and intentions of retail marketers who may ultimately be using the capacity that is renewed.

LDCs must also continue their ability to participate in the development of new capacity projects as well. Once again, the process involved and associated regulatory oversight must be responsive to current market conditions. Over time, the competitive market should assume greater responsibility and risk to develop capacity, however, it does not show signs of this level of maturity today.

4. Bay State's balanced "75-75" capacity assignment proposal is superior to either the pure voluntary or mandatory approaches.

The capacity assignment mechanism is the means by which an LDC's current capacity resources are offered to retail suppliers that acquire customers. Resources that are assigned are those in the portfolio today, including committed resources that have not been brought to market yet, as well as any new resources that are added to the portfolio or renewed in the future pursuant to ongoing capacity planning activities. Often the discussion of capacity assignment is reduced to a comparison of two extremes: a pure voluntary approach, in which the marketers have the ability to select only the assets in the LDC's portfolio that they desire, and the mandatory approach, in which the marketer must take a slice of the assets that are offered to it. In both cases, the quantities made available are based on the size and composition of the marketer's pool.

Bay State does not believe that the Department should be forced to implement either a pure voluntary or pure mandatory approach and has developed a proposal that is a blending or balancing of the two approaches and has significant advantages for the development of a competitive market over either. Before presenting this proposal, it is useful to examine some of the merits and limitations of the voluntary and mandatory approaches. These are summarized in the table that begins on the following page.

*Mandatory vs. Voluntary Capacity Assignment Approaches*

| | Merits | Limitations |
|---|---|---|
| Mandatory Assignment | • Eliminates the need to identify and recover potential stranded costs<br>• Shifts future market risk to retail marketers | • Resulting marketer portfolio may be less efficient<br>• Retail marketers may have different portfolio requirements to be efficient<br>• Shifts future market benefits to retail marketers (e.g., if FERC removes the release price cap)<br>• Capacity planning becomes more complex due to the uncertainty of capacity renewal/turnback decisions |
| Voluntary Assignment | • Marketers have access to firm primary delivery point capacity<br>• Marketers can develop portfolios to efficiently serve their customers<br>• Marketers can potentially provide greater savings to customers<br>• Will reduce the need for LDCs to contract for new capacity to meet load growth | • Creates the need to identify and recover potential stranded costs<br>• Requires increased administration of capacity releases to marketers by the LDC |

Bay State is proposing an integrated "75-75" approach to the complex issues of capacity assignment and allocation of stranded costs. Under this proposal, suppliers are automatically assigned 75% of their pool's pipeline and storage capacity requirements and may select up to 100% of their pool's requirements. The LDC would select paths which provide operating efficiencies to marketers and price all capacity at the system (or divisional, if appropriate) average in order to preserve equity between sales and transportation customers. The marketers would also guarantee that the LDC would recover 75% of the costs of the capacity that is not elected under this proposal. All the capacity available and therefore subject to the "75-75"

formula will be reduced if and when the LDC elects not to renew existing capacity contracts.[27] Assignments would be year-to-year with limited recall rights in the event of supplier non-performance or loss of load.

As indicated in Section III, the "75-75" capacity assignment approach provides a balance of the varied interests in the capacity debate. Specifically, assigning 75% of a supplier's capacity minimizes almost all of the potential for stranded capacity. Even if suppliers did not elect any of the remaining capacity, a significant amount of the unelected capacity would be used for system growth, offsetting the need to acquire incremental resources. Bay State estimates that it could accommodate migration from sales to transportation service of 10% per year initially without creating any stranded costs under its "75-75" proposal. The flexibility to self-source up to 25% of a pool's requirements at the outset offers suppliers the ability to deliver benefits for customers by reducing portfolio costs. The selection of paths also helps marketers manage the capacity that is assigned to them. Over time, suppliers will be able to increase the proportion of capacity that they are able to self-source if the LDC does not renew contracts or is able to capitalize on anticipated opportunities to assign capacity to emerging markets.

Bay State has estimated the transition costs that would need to be recovered under the "75-75" approach and alternative assumptions about the level of migration and the value of unelected capacity when it is optimized. As shown in Table B-3, which is presented in Attachment B, the impact on customer bills is less than 1% under all scenarios.

In summary, the "75-75" approach is a hybrid of the more extreme mandatory and voluntary approaches. Bay State believes that it appropriately balances the interests that lead parties to support either the mandatory or voluntary approach. The "75-75" proposal provides suppliers with some degree of sourcing flexibility providing for efficiency and innovation, while limiting the cost recovery issues and risks associated with a pure voluntary approach.

[27] Contract renewal decisions are made after consultations with marketers and Department review and approval (see "Capacity Planning" discussion).

5. The upstream capacity assignment approach will affect the development of a competitive market.

Many of the capacity assignment and pricing issues strike at the heart of the manner in which markets should be opened up. One important question to be answered is whether it should be a goal to ensure beneficial outcomes for all customers from the competitive environment, or whether it is preferable to work to afford all customers the same opportunities to benefit. Suppliers have noted that the fact that customers have a choice, whether they exercise it or not, adds value that should be considered when focusing on equitable pricing issues. In addition, there is an opportunity cost associated with creating a capacity pricing mechanism that is fair to all customers, but inhibits the development of a competitive environment.

6. Mitigation must be pursued through aggressive capacity management activities.

The complexity and importance of portfolio management activities increase as the market transitions from wholly bundled to partially unbundled. Portfolio management involves active planning of resources that remain in an LDC's portfolio to meet the continued needs of bundled and unbundled markets. The primary challenge is to continue to ensure that assets are utilized most efficiently even as the magnitude of the immediate transition is unknown.

The primary objective for managing capacity in the LDC portfolio is meeting the demands of its core markets on a daily and seasonal basis using the assets in the portfolio. This includes satisfying the demands of bundled customers who remain with the LDC as well as providing ancillary capacity services to suppliers. Even if all customers were to migrate to transportation service, the LDC would still require capacity resources to perform critical balancing and peaking services needed by suppliers. Once these core demands are met, the LDC must seek means of enhancing asset utilization through accessing non-core markets.

Bay State aggressively seeks to mitigate the costs in its portfolio by deploying assets to non-core markets when they would otherwise go unutilized. Bay State markets capacity to on-system interruptible customers and to off-system customers either through capacity release or off-system sales transactions. For the twelve-month period ending April 1997, these efforts yielded $10.2 million of margin revenues, reducing total fixed portfolio costs by 11.3%.

More recently there have been increasing occurrences where LDCs have outsourced the responsibility for portfolio management to a third-party asset manager. The types and magnitude of outsourcing range significantly from managing storage injections on a more limited scope to managing an entire portfolio on a broader scope. A primary reason for entering into an arrangement such as this is to lower costs to core customers through the potential increase in asset utilization that may result. It is important to recognize that these arrangements typically replace the other activities that an LDC might rely on to mitigate fixed costs, such as through capacity release. Additionally, the asset managers require a management fee as compensation.

Bay State has entered into arrangements with asset managers for management of its upstream storage capacity. In addition, Bay State continues to evaluate the opportunity to turn over management of more of its portfolio to an asset manager. To date, evaluation of potential deals revealed that the incremental increase in asset utilization did not offset the management fee. However, the terms for these types of arrangements continues to change necessitating ongoing evaluation.

7. Access to downstream assets is necessary to enable retail marketers to develop and manage efficient portfolios.

An LDC's on-system LNG and LPG assets are critical to the system both from the gas supply and distribution system perspectives. The on-system assets provide critical peak-shaving capacity to meet severe weather conditions. These same assets also provide pressure support in weaker areas of the distribution system. From a reliability perspective, the on-system assets are the nexus between the supply and distribution functions of an LDC.

In an unbundled environment, the on-system assets will continue to play a critical role for a number of reasons. First, they represent the most economic means of planning for and satisfying the needle peaking requirements of the coldest few days of the year. The on-system assets, which can be operated on short notice also allow LDCs to meet the increasing balancing requirements associated with broad scale unbundling. Lastly, the operating characteristics of the on-system assets are different than other types of assets allowing anyone with access to them to capitalize on unique opportunities. In particular, unlike pipeline assets, the peaking resources represent a fungible asset. Unused pipeline capacity on one day can not be utilized on a subsequent day, however, with LNG capacity, the tank capacity, although limited, can be reserved for future use without forgoing any opportunities.

Unbundling of the on-system assets must be approached in a different manner than the upstream resources. Naturally, as customers migrate to transportation, on-system capacity is freed up and should be made available to retail suppliers. Certainly, one of the best markets for these resources is on the LDC's system. However, unlike with upstream resources, a significant portion of the on-system capacity must be retained by the LDC in order to provide balancing and peaking services to supplier pools. The amount of capacity that is reserved for these purposes depends on the nomination and balancing protocols that are in place.

More importantly, however, the on-system assets are critical to the operation of the distribution system, especially during cold-weather periods. LDCs typically husband their LNG tank capacity to meet winter season design requirements. LDCs must retain sole discretion over when to run

their LNG plants both for economic and reliability concerns. This necessitates an approach that provides suppliers with virtual access to LNG assets through appropriately designed capacity and vaporization tariffed services.

In addition to the operational considerations, there are other factors that favor virtual rather than actual assignment of on-system assets. First, it does not make sense to run an LNG plant for a single supplier. Second, there are significant liability concerns associated with unbundling the injection of LNG into an LDC's tanks, which would be necessary under a traditional assignment approach. Lastly, the information systems are not in place to manage the transactions associated with actual assignment. This is not the case for upstream resources, where transactions can be completed through existing pipeline electronic bulletin boards.

## VI. THE AUCTION PROPOSAL

The Department has asked the parties to address the merits and limitations of a capacity portfolio auction. Bay State's comments on the portfolio auction reflect the discussions that Bay State has conducted over the past two years with asset managers (a service offered by some wholesale marketers), as well as discussions with other LDCs over the last nine months regarding this option. As a preliminary matter, it is important to recognize that a portfolio auction or outsourcing RFP is not tied to the unbundling of an LDC's services. Successful unbundling of an LDC's services does not require outsourcing of the portfolio nor does portfolio outsourcing necessarily contribute to the benefits that are achieved through unbundling. Many LDCs have entered into outsourcing arrangements of various scopes that precede the introduction of customer choice. The benefits of outsourcing under these arrangements have been passed on to the LDC's sales customers as they will be under the LDC auction proposal. However, the pattern of customer migration becomes one of the critical elements of a portfolio auction as it will affect the proposals offered by wholesale marketers. This fact significantly complicates the contractual arrangement that must be negotiated and the evaluation that must be performed to determine if customers will benefit as a result of this option.

As indicated above, Bay State has studied outsourcing the city-gate gas supply service over the past two years and believes that this is a viable approach that should continue to be evaluated in the future. However, Bay State's discussions with wholesale marketers have not resulted in potential opportunities that would result in incremental savings to its customers, over and above the savings that are currently being passed through as a result of our own optimization efforts. In evaluating these opportunities, it is also necessary to assess the allocation of market risk between the wholesale marketer and the LDC (and its customers) under the outsourcing contract.

Market conditions will change in the future, and thus Bay State will continue to engage in discussions with wholesale marketers in order to take advantage of savings that are achievable. It is also possible, if not likely, that the asset management services offered by wholesale marketers will change significantly over the next few years and entirely new options or approaches will be developed to respond to the market needs of LDCs during the transition period. Imposing a

multiple-year auction at this time could foreclose the ability of an LDC to take advantage of superior options that develop in the interim. This may be appropriate if there are substantial incremental savings to be realized, but makes little sense if the savings are marginal or uncertain at best. For these reasons, Bay State strongly supports making the auction or outsourcing opportunity an option that may be elected by LDCs and not a mandatory requirement imposed by the Department as part of an unbundling proceeding.

1. While the portfolio auction approach has appeal, it has significant drawbacks with respect to opening markets to competition.

The auction proposal is essentially a comprehensive, long-term asset management agreement with a wholesale marketer. The approach presents benefits as well as costs and risks, especially when considered in light of the fact that the industry is undergoing a significant restructuring of the retail segment. Bay State offers its analysis of the merits and limitations sought by the Department from its perspective.

The merits of the auction proposal from Bay State's perspective are:

- Potential benefits that derive from the ability of the wholesale marketer to better optimize a portfolio through more diverse and in-depth market knowledge and ability to more effectively leverage assets in connection with others available to the wholesale marketer;
- Potential that the wholesale marketer will have a different risk profile that enables it to offer guaranteed and incremental benefits to the LDC as compared with the benefits realized by self-optimization; and
- The LDC resources (primarily labor) that are freed as a result of shifting certain gas supply responsibilities to the wholesale marketer.

The limitations of the auction proposal from Bay State's perspective are:

- There is a natural conflict between asset managers that can derive a higher value from the assets if they know what level of migration will occur throughout the term of the contract and the desire to have market forces determine the level and pattern of migration. Restrictions on migration will have an adverse impact on customers (particularly customers who are prevented from exercising choice when they are ready to do so) and on marketers whose cost of doing business or market penetration may be adversely affected by constraints on migration.

- If the asset management agreement includes a requirement that the asset manager provides a supply service at a fixed-price, the LDC's customers will be forced to assume this increased price risk. This contrasts significantly with a fixed-price service that is offered by the LDC as an option to customers. The potential for customer dissatisfaction due to this price risk is significant if market prices decline below the fixed price and customers are prevented from switching to an alternative supplier because of migration limitations put in place to benefit the asset manager. Under these circumstances, customers have the perception of choice, but not the reality.

- The auction proposal may inhibit the development of a competitive market because the insertion of a wholesale marketer in the middle of the capacity assignment process may make the market less attractive to retail marketers relative to other emerging markets in the country. These wholesale marketers may also develop the ability to exercise market power, if asset transfers are not subject to review with this objective in mind. This is an important issue because it is possible that a significant portion of the gas supply assets serving a market area will be transferred from LDCs which are regulated, to wholesale marketers that may have the ability to exercise market power. While the Department may have serious concerns about the potential exercise of market power, it may lack the jurisdiction to address these concerns.

- Asset managers require substantial management fees in return for the services they provide; because the ability to generate benefits is due in large part to the ability to control assets, which LDCs are able to do independently of the asset manager, the incremental benefits of working with an asset manager must be assessed compared with the costs and risks of doing so.

- An LDC will not be able to shed gas supply management resources entirely; significant resources will be needed to manage the relationship with the asset manager in order to ensure continued reliability of service.

- One of the best means of optimizing the value of upstream resources is through the integration of an entire portfolio, i.e. both upstream and on-system assets, because on-system assets can be used to displace upstream assets, which can then be sold into other markets to generate incremental value. Outsourcing the on-system assets with the upstream assets as a package in order to gain this benefit through a third-party is nearly impossible because of the discretion LDCs need to dispatch on-system assets on a moment's notice to meet changing customer demands.

- The market for asset management is highly competitive and changing rapidly; LDCs that enter into multi-year agreements may forego benefits that would have otherwise been available through more attractive offers at a later date (e.g., any removal by the FERC of the cap on capacity release price, a potential policy change which would increase the value of capacity).

- Market conditions in New England will undergo a radical change over the next few years with the introduction of new pipeline capacity and the increased demand generated by new power plant projects. This uncertain environment would dictate that an LDC maintain capabilities in asset management in order to take advantage of new market opportunities.

2. The auction analogy to the electric restructuring is not relevant due to industry structure differences.

The auction proposal appears to be formulated based on comparisons to the restructuring of the electric industry in Massachusetts. The analogy between divestiture of generation assets to gas supply outsourcing breaks down due to fundamental differences in the two industries. The major differences are highlighted below:

- The electric industry is vertically integrated. Separating the generation assets from the utility's distribution function provides far greater competitive stimulus than in an industry that was not vertically integrated prior to the introduction of competition. A regional electricity capacity and energy market was also created with significant protections in place to ensure that generation and transmission sellers are not able to exercise market power.

- The electric generation markets have not been subject to competition and are clearly priced above market-clearing prices today. On the contrary, the wholesale gas supply and transportation markets have been deregulated to differing degrees for 20 years.

- Gas supply upstream pipeline and storage assets are contractual, rather than hard assets. There are limits on the ability to "sell" gas supply assets at prices above book (i.e., contracted-for) value. These limits are established in the FERC's capacity release rules.

- A robust secondary capacity market already exists in the gas industry enabling LDCs to easily gain access to markets and optimize use of their own assets.

3. If the Department finds that a portfolio auction is consistent with customer choice, it should find that the auctioning of assets is optional and should not mandate that all LDCs "auction" their portfolios.

As a preliminary matter, it is important to note that the value of the auction approach may differ significantly among LDCs. The auction proposal is not intrinsic to offering choice to Massachusetts customers, either in terms of facilitating choice or protecting remaining customers from any adverse impact from migration of customers from sales service. While Bay State understands that it may be an excellent option for some LDCs, Bay State does not believe it is reasonable for the Department to impose the approach on all LDCs. If the Department finds that a nexus exists between the auction proposal and the introduction of customer choice, it should allow LDCs to enter into the contemplated outsourcing agreements on a voluntary rather than mandatory basis.

## VII. STATUTORY AND/OR REGULATORY CHANGES REQUIRED TO IMPLEMENT CUSTOMER CHOICE

The regulatory changes that will be required in order to implement customer choice include policy direction from the Department regarding the issues that are being addressed in this proceeding, decisions coming from subsequent Department review of changes to LDC tariffs to comply with the policy directives, as well as a new set of regulations which will revise the existing LDC Forecast and Supply Plan review process to correspond to a customer choice environment. Bay State has included a proposed Forecast and Supply Plan review process as part of its comprehensive proposal that is presented in Section III.

It is Bay State's belief that the existing statute, as recently amended by the electric restructuring legislation, provides the Department with the necessary authority to implement customer choice and to oversee both LDCs and retail marketers after the new market structure is put in place. Nonetheless, it is clear that the General Court will have an interest in understanding natural gas customer choice and the differences between the natural gas industry and the electric industry. Therefore, Bay State urges the Department to proactively communicate its natural gas policy objectives and implementation efforts to the General Court.

Some of the key distinctions between the natural gas and electric industry restructuring efforts are:

- Many natural gas customers in Massachusetts have had a transportation option since the 1980s and are currently purchasing natural gas from a retail marketer; in contrast, retail competition in the electric industry could not have been implemented without statutory changes.
- The electric industry was vertically integrated prior to restructuring; the natural gas industry already had separate production, transmission, storage and distribution segments with significant restructuring efforts having been completed by the FERC, with benefits from competition being realized in all but the distribution segment.
- The upstream assets of natural gas distribution utilities are contractual rights to use facilities owned by other entities for fixed terms; the power plants owned by electric

utilities are physical assets that have value that in some cases exceed their book value because of their future life and/or site location.

- Electric utilities sought recovery of several billion dollars of costs that were identified as stranded costs and recovery was provided through a funding process established by the General Court; natural gas utilities face potential stranded costs that are a small fraction of these levels and there is no need for securitization of these liabilities.

- The circumstances that led to the offer of an initial discount for "standard offer service" in the electric industry do not exist in the natural gas industry and should be avoided if the discount is only likely to result in a deferral of current costs to future years.

In summary, the public policy concerns raised by natural gas industry restructuring are not comparable to those that existed in the electric industry. Once again, Bay State recommends that the Department work with members of the General Court to determine whether legislation is needed from their perspective.

## VIII. SUMMARY OF PROPOSED FINDINGS AND RECOMMENDATIONS

Proposed Findings:

1 Creating a sufficiently competitive market place is necessary for all customers to benefit from choice. (Reference: page 3)

2 The competitive environment must be consistent with the expectations that are communicated to customers. (Reference: page 4)

3 Many customer choice objectives are potentially in conflict; the Department must find the appropriate balance. (Reference: page 5)

4 Other customer choice efforts provide some guidance to the Department, although the value may be limited by important regional differences. (Reference: page 7)

5 The most relevant experience, particularly if one is concerned about the ability of residential and small customers to benefit from choice, is Bay State's pilot. (Reference: page 8)

6 The LDC is entitled to recover all transition costs that are associated with prudently incurred commitments. (Reference: page 15)

7 It is appropriate to allocate a diminimus level of transition costs to customers who elect to elect to defer choosing a competitive supplier until some future date. (Reference: page 16)

8 The issues of capacity assignment, planning and management must be considered together during the transition period. (Reference: page 24)

9 The reliability of service must be maintained throughout the transition period. (Reference: page 26)

10 The LDC must continue to play a central role in capacity planning. (Reference: page 28)

11 Bay State's blended "75-75" capacity assignment proposal is superior to either the pure voluntary or mandatory approaches. (Reference: page 31)

12 The upstream capacity assignment approach will affect the development of a competitive market. (Reference: page 34)

13 Mitigation must be pursued through aggressive capacity management activities. (Reference: page 34)

14 Access to downstream assets is necessary to enable retail marketers to develop and manage efficient portfolios. (Reference: page 36)

15 While the portfolio auction approach has appeal, it has significant drawbacks with respect to opening markets to competition. (Reference: page 39)

16 The auction analogy to the electric restructuring is not relevant due to industry structure differences. (Reference: page 41)

17 If the Department finds that a portfolio auction is consistent with customer choice, it should find that the auctioning of assets is optional and should not mandate that all LDCs "auction" their portfolios. (Reference: page 42)

Proposed Recommendations:

Bay State's proposed recommendations are summarized in the Executive Summary and discussed in more detail in Section III.

**Attachment A**

**Bay State Gas Customer Choice Collaborative**

**Guiding Principles**

**1** Unbundle services and rates to ensure full and fair competition in retail natural gas product and service markets that are sufficiently competitive.

2 Provide the broadest possible customer choice, facilitating customer participation without forcing customers to purchase from a competitive supplier before they are comfortable with such a choice.

3 Ensure that the transition is orderly and expeditious and minimizes customer confusion.

4 Provide all customers the opportunity to share in the benefits of increased competition.

5 Continue protections for residential customers, including low-income protections, equivalent with those they receive under the existing DPU regulatory requirements.

6 The obligation to serve all connected firm customers shall continue, although the role of the LDC may change with the introduction of marketers; LDCs continue to connect new customers subject to an appropriate economic test.

7 Maintain the reliability of service, consistent with customers' desires.

8 Honor existing prudently incurred commitments, providing a reasonable opportunity to recover stranded costs fairly, while encouraging LDCs to mitigate such costs.

9 Continue market transformation of demand-side management programs.

**Attachment B**

**Response of Bay State Gas Company**
**to Department Question No. 1 –**
**Potential for Stranded Costs**

The potential for "stranded" costs is an important element in evaluating alternative approaches to providing customer choice. By "stranded" costs, Bay State refers to those costs which are prudently incurred and would have been recovered from customers by the LDC, but which now may require some new approach to cost recovery. As a general matter, new gas supply costs are not created as a result of offering choice to customers.[1] In the pre-choice environment, LDCs minimize the cost of providing sales service by making optimal contracting decisions (although "lumpy" at times to reflect the nature of the capacity contracting market), and then maximize the utilization of the assets, first for on-system firm requirements, and then by serving interruptible customers and making off-system sales of both bundled and unbundled resources.

The LDC will continue these activities after customer choice is offered. However, the potential for existing costs to be stranded as a result of the transition is created if the costs recovered as a result of the capacity assignment process are less than the costs that would otherwise have been recovered had those assets continued to be required by and used to meet the needs of sales customers. The merits and limitations of alternative approaches to capacity assignment are discussed in Section V of Bay State's comments and will not be repeated here. However, it is critical to recognize that stranded cost mitigation can occur at several steps of the capacity contracting and assignment process. For this reason, Bay State has presented its proposal as an integrated "capacity assignment, planning and management" proposal.

[1]1 The transition to a customer choice environment will require the LDC to incur significant costs associated with modifications to systems and processes, and the development of new systems and processes to support a choice environment. These costs, which are transition costs, are not addressed in this attachment.

In its question, the Department has asked for identification of the costs that could be "theoretically" stranded as a result of the unbundling process. Theoretically, each of Bay State's resources that are not used to provide unbundled service in the future (either by Bay State or by a retail marketer) may result in costs that are potentially stranded. For gas supply resources, this includes all of the upstream and on-system resources that are in Bay State's portfolio. These resources are identified in Table B-1 which provides the contract quantity, term and renewal provisions for each resource as well as the annual fixed costs for each upstream resource.

The extent to which any of the potentially stranded resources are actually stranded at some point in the future depends on a number of factors including characteristics of the LDC's existing portfolio, unbundling program design, system load growth and future capacity market conditions. While future capacity market conditions can not be predicted with certainty, the certain elements of an unbundling program design have a significant impact on the potential for stranded costs. Some of these program design elements and their impact on the potential for stranded costs are described below:

- **Capacity Assignment:** Voluntary assignment will lead to more stranded costs in the short-run than mandatory assignment. Additionally, the greater the degree of voluntary assignment, the greater the potential for stranded costs. Other facets of the capacity assignment approach can mitigate the potential for stranded costs including using a slice or average cost approach, and requiring assignments to be for annual periods. Lastly, many factors will mitigate the stranded costs that may result from voluntary assignment including: using unelected capacity for system growth, capacity release, off-system sales, etc.

- **Nominations and Balancing Protocols:** If the LDC retains a balancing function as Bay State has done in its pilot program, it will need to retain some resources in its portfolio.

- **Capacity Planning:** A change in the LDC's role in the capacity acquisition and renewal process will significantly affect the level of stranded costs. For example, LDCs should no longer be required to acquire capacity to meet the peak and annual requirements of all of their customers, if some are being served by competitive marketers. At the same time, the LDC

should be allowed to control capacity renewal rights so that it can contract for capacity where it is necessary that the LDC continue to do so in order to maintain reliability. This will minimize costs by preventing the need to acquire incremental capacity at expensive prices if a shortage develops that could have otherwise been met by renewing existing capacity dedicated to Massachusetts markets.

**Table B-1**

- **Transition Period:** Ensuring a smooth transition to a competitive market at a pace desired by customers will prevent problems associated with transferring all of the customers and associated remaining assets to the marketplace at a single point in time.

These factors have a significant impact on the potential stranding of costs. The Department also identified three key business environment factors that affect the degree of transition costs. The first is the amount of capacity transferred to marketers for serving current customers who enter the competitive market (under either voluntary or mandatory approach). The second is the degree (or pace) of migration that occurs, and the third is the value that the LDC can obtain for any unelected capacity through mitigation efforts such as off-system sales or capacity release or to meet system growth. Of course, if 100% of the capacity is transferred to marketers, if no migration occurs, or if the LDC can obtain full value for its assets, no stranded costs will result.

Bay State has analyzed the potential for stranded costs based on the portfolio of resources presented in Table B-1 and the potential outcome for the three key variables described above. The results of this analysis are presented in summary form in the following two tables. Table B-2 assumes a pure voluntary assignment methodology where marketers elect not to take assignment of any capacity, representing a pessimistic or extreme result if a pure voluntary assignment mechanism would be put in place. The results also assume that stranded costs are spread equally across all customers, however, an alternative allocation between sales and transportation customers could be developed. This table assumes that Bay State continues to grow at 2.5%, which is below Bay State's historical average growth rate.

**Table B-2**
**Potential Annual Stranded Costs, Unit Surcharge**
**And Typical Bill Impact for Residential Heating Customers**
**Under a Pure Voluntary Assignment Approach**
(0% Capacity Elected)

| | | Mitigation of Unelected Capacity | | |
|---|---|---|---|---|
| Migration | | **75% Mitigation** | **50% Mitigation** | **25% Mitigation** |
| **25%** | Stranded Costs ($MM) | $5.5 | $10.9 | $16.4 |
| | Unit Rate ($/MMBtu) | $0.114 | $0.228 | $0.342 |
| | Bill Impact | 1.3% | 2.6% | 3.9% |
| **50%** | Stranded Costs ($MM) | $11.5 | $23.1 | $34.6 |
| | Unit Rate ($/MMBtu) | $0.240 | $0.481 | $0.721 |
| | Bill Impact | 2.7% | 5.5% | 8.2% |
| **75%** | Stranded Costs ($MM) | $17.6 | $35.2 | $52.8 |
| | Unit Rate ($/MMBtu) | $0.367 | $0.734 | $1.101 |
| | Bill Impact | 4.2% | 8.4% | 12.6% |

Table B-2 analyzes the exposure assuming suppliers reject 100% of Bay State's capacity if they had the opportunity to do so and therefore represents a pessimistic view, however it does provide an estimate of "theoretically" stranded costs sought by the Department. Table B-3, which follows, reflects the level of stranded costs that would result if Bay State's "75-75" capacity assignment proposal were adopted.

**Table B-3**
**Potential Annual Stranded Costs, Unit Surcharge**
**And Typical Bill Impact for Residential Heating Customers**
**Under Bay State's "75-75" Capacity Assignment Proposal**

| | | Mitigation of Unelected Capacity | | |
|---|---|---|---|---|
| Migration | | **75% Mitigation** | **50% Mitigation** | **25% Mitigation** |
| **25%** | Stranded Costs ($MM) | $0.9 | $1.8 | $2.7 |
| | FT rate ($/MMBtu) | $0.019 | $0.095 | $0.171 |
| | FS rate ($/MMBtu) | $0.019 | $0.019 | $0.019 |
| | FS Bill Impact | 0.2% | 0.2% | 0.2% |
| **50%** | Stranded Costs ($MM) | $2.4 | $4.8 | $7.3 |
| | FT rate ($/MMBtu) | $0.051 | $0.152 | $0.253 |
| | FS rate ($/MMBtu) | $0.051 | $0.051 | $0.051 |
| | FS Bill Impact | 0.6% | 0.6% | 0.6% |
| **75%** | Stranded Costs ($MM) | $3.9 | $7.9 | $11.8 |
| | FT rate ($/MMBtu) | $0.082 | $0.192 | $0.302 |
| | FS rate ($/MMBtu) | $0.082 | $0.082 | $0.082 |
| | FS Bill Impact | 0.9% | 0.9% | 0.9% |

As indicated by a comparison of these two tables, Bay State's proposal limits the potential for stranded costs considerably under any scenario. Even with a 75% migration rate and 25% mitigation of remaining resources, the impact on sales customers is less than 1%. This figure is likely to be conservative, if one assumes that Bay State will adjust its portfolio under these circumstances. Additionally, some of the potential outcomes are more likely than others. In the earlier years, Bay State believes that a range of migration of 25-50% and mitigation of 50-75% is most likely. Under Bay State's proposal, this would equate to stranded costs of only $1-5 million, the majority of which would be borne by converting customers. Even these amounts do not take into consideration additional years of growth that might occur after the first year or opportunities to decontract that will arise in future years. This latter point is critical, and explains

why the Department must approach capacity assignment, planning and management on an integrated basis.

**Attachment C**

**Response to the Department's April 10, 1998 request for additional information, Item No. 9, Domestic Experience with Unbundled Service**

In response to the Department's research request, Bay State has prepared an assessment of its own residential pilot program, in line with the research topics the Department has outlined.

## THE BAY STATE GAS CUSTOMER CHOICE PILOT

### *Background*

In the Spring of 1996, Bay State Gas invited a diverse group of gas industry stakeholders, including government officials, utilities, marketers and consumer groups, to participate collaboratively in the design of a two-year residential unbundling pilot, which enabled participants to choose their gas supplier. The program became one of the largest and most innovative pilots of its kind in the nation, and introduced competition and choice to residential customers in New England for the first time. In particular, the collaborative process resulted in a relatively "open" design that approximates competitive conditions as closely as possible. These stakeholders reconvened in the Spring of 1997 in an effort to design program enhancements for Year 2 before moving forward with efforts to design a program to offer choice to Bay State Gas customers system-wide in the Spring of 1998 in the form of a comprehensive settlement proposal to the Department. As a result of this collaborative effort, the pilot was expanded to include small commercial customers in August 1997. Almost 28% of all eligible customers are currently participating.

*1* ***Indicate the dates on which the program was approved, program size limitations, enrollments initiated, enrollment terminated, service initiated.***

The first year of Bay State's pilot, *Pioneer Valley Customer Choice*, was approved by the Department in July, 1996. Eligibility was limited to the first 10,000 Springfield-area residential

customers who enrolled during the period beginning August 1, 1996 and ending October 15, 1996. Unbundled sales and delivery services began on November 1, 1996 for a one-year term ending October 31, 1997.

The second year of the pilot, *Choice Advantage from Bay State Gas,* was approved by the Department in July, 1997. There was no enrollment cap; all of the approximately 83,000 Springfield-area residential customers were eligible, as were all of Bay State's 6,000 small business customers in that area, as well as all of the company's 10,000 small business customers in the Brockton area. Enrollment has been permitted throughout the year, allowing suppliers to add customers on a continual basis. Unbundled sales and delivery services for Year 2 began on November 1, 1997 for a one-year term scheduled to end on October 31, 1998.

*2* ***Review the extent and monthly rate of customer migration, together with the nature of the enrollment period (fixed or rolling).***

Year 1 enrollment was limited to the period from August 1, 1996 through October 15, 1996, and enrollment was capped at the first 10,000 of the 83,000 customers eligible. Below are the approximate monthly rates of customer migration:

| 1996 | Aug. | Sept | Oct. |
|---|---|---|---|
| | 300 | 3,500 | 6,400 |

The marketers got a late start during the first year of the pilot and Bay State believes that the 10,000 cap would have easily been reached if the enrollment period were extended for another month.

Year 2 enrollment is continuous, and 99,000 customers were eligible. Below are the approximately monthly rates of customer migration:

| ***1997*** | Aug. | Sept. | Oct. | Nov. | Dec. | ***1998*** | Jan. | Feb. | Mar. | Apr.(15) |
|---|---|---|---|---|---|---|---|---|---|---|
| | 7,200 | 8,100 | 17,000 | 19,000 | 22,000 | | 24,300 | 27,200 | 27,600 | 27,200 |

*3* ***Describe the principal attributes including, but not limited to, voluntary or mandatory assignment and cost responsibility.***

Capacity has been made available to suppliers on a voluntary basis during both years of the Pilot. Suppliers are entitled to elect either 100% or 0% of an allocated share of pipeline capacity based on applying the respective class-specific percentages of pipeline capacity to the peak day requirements for that class. Capacity is priced at average cost, and must be acquired for an initial term of one year. All revenues from suppliers for use of capacity is being credited to the CGA applicable to Bay State's bundled sales service. Unelected capacity is first used to meet system growth and then remaining unelected capacity costs are mitigated through capacity release and off-system and interruptible sales.

*4* ***Discuss the impact upon each major class of stakeholder including, but not limited to, the LDC and residential end users.***

The pilot has generated significant learning for Bay State, suppliers and other participating stakeholders while saving customers money. All stakeholders have learned how residential and small-business customers behave in a choice environment, and that savings, convenience and a continuing service role for the gas utility are what matter most to migrating and non-migrating customers. In addition, Bay State has learned how to treat suppliers as trade allies, enabling them to maintain a high level of customer satisfaction while delivering real savings. The company has also gained valuable information about the business processes and administrative support systems required to serve smaller firm transportation customers. Bay State benefited from the opportunity to learn how to work collaboratively with a broad range of stakeholders to design new approaches to meeting customers' needs. The 24,000 residential and 3,000 small-business customer participants have benefited from savings on their gas bills (compared to Bay State burner-tip prices) averaging 13% in Year 1 and 6% in Year 2. In addition, these customers have a better understanding of their new roles and responsibilities as gas consumers in a choice environment. Bay State's quarterly survey research evaluation effort has been extremely valuable in assessing perceptions and attitudes toward these issues among pilot participants and non-participants. A unique feature of the research is its focus on customers' evaluation of marketer performance.

After a slow start, participating suppliers have been continually increasing their understanding of what is required to satisfy small retail gas customers, and have upgraded their customer service capabilities to the point where, currently, 85% of residential customers are *completely* (41%) or *mostly* (44%) satisfied with their supplier's overall performance.

*5* ***Discuss the way(s) by which decisions are to be reached on capacity renewal and capacity additions necessary to provide for system growth.***

Approaches to long-term capacity planning were not included in the design of Bay State's pilot. However, stakeholders intended that the learning generated by the pilot regarding customer and supplier behavior in a choice environment would be valuable in designing the approach to capacity planning and capacity additions (or renewals) that would be an important feature of Bay State's 1998 full customer choice filing. This learning has served as an important factor in the development of the Customer Choice Proposal Bay State is submitting for the Department's consideration within this filing. In particular, the pilot has shown that during the early years of unbundling it is reasonable to expect that the suppliers doing business on Bay State's system will change from year-to-year, and that the LDC will need to play a continuing central role in pursuing system growth in acquiring capacity to meet growing gas demand.

*6* ***Indicate the marketers (including affiliation) that participated in the residential unbundling program.***

Year 1

NorAm Energy Corp. (affiliate of Houston Industries)
Broad Street / EnergyOne (affiliate of Utilicorp United)
Green Mountain Energy Partners (affiliate of Green Mountain Power)
KBC Energy Services (affiliate of Bay State Gas)
WEPCO Gas
National Fuel Resources (affiliate of National Fuel Gas Co.)
Western Gas Resources
AllEnergy Marketing Company (affiliate of Eastern Enterprises/New England Electric System)
Total/Louis Dreyfus Energy Services (affiliate of Connecticut Energy Corporation)
Global Energy Services

Year 2

NorAm Energy Management (affiliate of Houston Industries)
L.E. Belcher, Inc.
WEPCO
AllEnergy (affiliate of New England Electric System)
Utilicorp Energy Solutions (affiliate of Utilicorp United)
National Fuel Resources, Inc. (affiliate of National Fuel Gas Co.)
Texas-Ohio Gas, Inc.
EnergyExpress (affiliate of Bay State Gas)
Enron
Energis Resources (affiliate of Public Service Electric & Gas Co.)

*7* ***Discuss the ways by which capacity assignments were made and discuss the extent to which the limited extent of a pilot program limits the significance of that experience when developing a program for phased-in unbundling.***

Any pilot, by design, is bound to be a proxy for a fully competitive, unbundled marketplace. However, the more circumscribed the design parameters, the more limited will be its value as an indicator of customer and supplier behavior in a fully competitive marketplace. Moreover, even where a pilot has been designed to be as unfettered and reflective of the future competitive environment as possible, some caution must be exercised in applying the learning to different regions of the country where the capacity supply/demand balance is different.

These concerns were the key drivers of Bay State's decision to conduct its own New England-based pilot, and to design the pilot to be as open and reflective of a fully competitive environment as possible. Because, even at this late date, *Choice Advantage* is the only such experiment in New England, careful attention to its progress and results is warranted. Particularly since the New England region is capacity constrained and undersaturated when compared to the rest of the nation, Bay State believes its pilot provides the most relevant experience available if the intent is to structure an approach to unbundling that truly benefits residential and small-business customers in this region. It is worth noting that all 10 pilot suppliers were able to deliver reliable commodity sales service to residential and small-business customers, regardless of whether their capacity portfolios consisted of 100% or 0% of Bay State's upstream pipeline and storage resources, on the Tennessee and TETCO-Algonquin systems.

Although it would not be prudent to view this pilot experience as a certain indicator of future market behavior, Bay State believes these results are significant, particularly in the absence of any other field evidence of how residential choice may develop in the New England region.

As stated in the response to (c) above, capacity has been made available to suppliers on a voluntary basis during both years of the Pilot. Suppliers are entitled to elect either 100% or 0% of an allocated share of pipeline capacity based on the ratio of pipeline capacity to peak day requirements for the customers in their pool. This ratio, which varies for the residential and small C&I high winter use and small C&I low winter use customer groups was calculated by Bay State in its peak period 1997-98 CGA filing. Suppliers electing their allocated share of pipeline capacity in the Springfield location have acquired Tennessee Gas Pipeline capacity, while suppliers electing their allocated pipeline capacity share in the Brockton location are receiving Algonquin Gas Transmission and Texas Eastern capacity. Capacity is priced at the location-specific average cost of all pipeline capacity serving that location, and has been acquired for an initial term of one year. Suppliers that increase their pool size have an option to acquire additional pro rata capacity monthly.

Suppliers that elect pipeline capacity are allocated a pro rata share of the supply legs that feed the mainline capacity. In particular, suppliers in the Springfield location receive entitlements on Tennessee Gas Pipeline's 100, 500 and 800 supply legs, while suppliers in the Brockton location receive entitlements on Texas Eastern's South Texas, East Texas, West Louisiana and East Louisiana supply legs. In addition, Brockton suppliers receive 70% of the capacity under Algonquin's no-notice AFT-E service and 30% under Algonquin's AFT-1 service.

Suppliers may meet their pool's requirements using voluntarily elected Bay State capacity, Bay State's no-notice supplemental supplies, or any other resources that they can access for delivery to Bay State's city gates. The capacity assignment mechanism was all-or-nothing. Suppliers are obligated to establish a daily maximum delivery equal to at least their pool's pipeline capacity entitlement. They may establish a higher daily maximum if they elect Bay State storage capacity or plan to use non-Bay State resources to meet their pool's requirements. On any given day,

forecast requirements up to the daily maximum are the supplier's obligation, and requirements above that level are met through Bay State's cost-based, no-notice supplemental supply service.

***(h) Identify the cost responsibility for "stranded" capacity and the amount of those stranded costs;***

***(i) Indicate the extent to which stranded costs were reduced through mitigation.***

Stakeholders in Bay State's 1996 and 1997 collaboratives agreed that the issue of "cost responsibility" would be more appropriately considered in the context of a full unbundling proposal, rather than during a pilot which would be limited in size (particularly in Year 1) and designed primarily to be a learning laboratory. Consequently, stakeholders determined that it would be appropriate for Bay State to focus on maximizing its efforts to mitigate the cost of any stranded capacity that was not required to meet system load growth. Then, any unmitigated costs – expected to be a relatively small amount – would be recovered through the CGA charged to all of the company's bundled sales customers in Massachusetts, resulting in a diminimus impact on their bills.

Year 1

Because of the relatively small number of migrating customers and the high percentage (approximately 80%) of Bay State's upstream capacity elected by suppliers in Year 1, there was very little unelected capacity for Bay State to mitigate. Substantially all of this capacity was used to meet system load growth requirements, so virtually no mitigation of these costs was required.

Year 2

Migration accelerated and the percentage of upstream capacity elected by suppliers began to diminish in Year 2. Through the end of March 1998, essentially at the close of the 1997-98 heating season, the total upstream capacity requirements being sourced by competitive suppliers

to serve their customers was 13,082 dth. Approximately 7,700 dth or 59% of this available upstream capacity was elected by suppliers to serve their pilot customer pools.

Bay State mitigated the unelected upstream capacity as part of the optimization performed on its entire portfolio and did not track the mitigation of unelected pilot capacity separately. However, it is important to note that this capacity was available to satisfy Bay State's annual growth in system requirements which average approximately 2% per year. This translates to an annual increase in upstream capacity requirements of approximately 4,200 dth per year.

***(j) Discuss the extent to which the requirement for either mandatory assignment or the portfolio auction of LDC capacity appears to have affected the development of the unbundling program.***

Neither mandatory capacity assignment nor auctioning of Bay State's capacity portfolio were required as a component of the pilot program. However, based on collaborative learning during the design of these programs and subsequently, it became apparent that competitive suppliers would be less interested in serving Bay State's customers under a mandatory assignment approach than the voluntary one reflected in the pilot.